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THE ARBITRATION OF A PUBLIC SECURITIES DISPUTE

CONSTANTINE N. KATSORIS*

INTRODUCTION

IN the United States, the status of the economy is measured daily on the basis of its financial markets. This appraisal is reflected and reported with great fanfare by the media. Almost everyone has an opinion about the market, and for many—after a glimpse at the headlines—the financial section is their first stop in perusing the morning newspaper. The market's performance controls investment and political decisions at every level of our society. In short, the struggle between the "bulls" and the "bears" is more than just a national pastime.

Increasingly, the public is using these security markets as investment vehicles to achieve total return directly through income and capital gain,¹ or indirectly through Individual Retirement Accounts,² Keogh plans and other pension devices.³ In addition, the array of investment vehicles available to the public has been constantly expanding.⁴ This broader public involvement in financial markets has led to increased litigation between the public and members of the securities industry.⁵

Last year these litigations numbered in the thousands.⁶ With greater frequency, however, these disputes are being channelled into arbitration

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1. Net capital gains are taxed at a maximum federal tax rate of 20%. See I.R.C. § 1202(a) (1982) (60% deduction for capital gains); I.R.C. § 1 (Supp. 1984) (for all categories maximum tax rate is 50%). Recently the long term holding period has been lowered to six months from one year. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 1001(a), 98 Stat. 494, 1011, *reprinted in* 1984 U.S. Code Cong. & Ad. News 1011 (to be codified at I.R.C. § 1222).

2. See I.R.C. § 219 (West Supp. 1984).

3. See I.R.C. §§ 401(c), 404, 415(b),(c) (West Supp. 1984).

4. See Maidenberg, *Futures/Options, Young Markets Play Key Role*, N.Y. Times, Aug. 6, 1984, at D6, col. 3 (increased use of index and option markets enables institutional investors to transfer huge cash reserves into stock market).

5. See Statistical Analysis and Reports Division, Administrative Office of U.S. Courts, Federal Judicial Workload Statistics A-9 (March 31, 1984) (during twelve-month period ended March 31, 1984, over 3,000 securities and commodities exchange civil actions were filed in federal district courts) [hereinafter cited as Statistical Report]; see also Stern, *Malpractice for Brokers*, Forbes, March 26, 1984, at 38 ("[T]here is a growing, generally unpublicized number of suits against brokerage firms involving oil and gas shelters.").

6. See Statistical Report, *supra* note 5, at A-9.

before forums established by the various Security Regulatory Organizations (SROs) such as the New York Stock Exchange and the National Association of Securities Dealers.⁷ Arbitration provides the advantage of speedy dispute resolution by persons knowledgeable in the area, without

7. See Fourth Report of the Securities Industry Conference on Arbitration Statistical Report (Nov. 1984) Exhibit A — (available in files of Fordham Law Review) [hereinafter cited as Fourth Report]. The SROs include the following members: American Stock Exch.; Boston Stock Exch.; Chicago Bd. Options Exch.; Cincinnati Stock Exch.; Midwest Stock Exch.; Municipal Sec. Rulemaking Bd.; National Ass'n of Sec. Dealers, Inc.; New York Stock Exch.; Pacific Stock Exch.; and Philadelphia Stock Exch. *Id.* at 12. The bulk of said arbitrations are handled before the National Association of Securities Dealers and the New York Stock Exchange. *Id.* at Exhibit A—Statistical Report. The following is a breakdown of the arbitrations handled by the arbitration facilities of the various SROs:

COMPOSITE FIGURES

	Total Cases Received	Total Cases Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	830	686	332	269	410	205
1981	1,042	980	306	357	532	264
1982	1,340	1,044	322	292	558	293
1983	1,731	1,259	416	320	622	331

AMERICAN STOCK EXCHANGE, INC.

	Total Cases Received	Total Cases Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	45	41	18	11	35	16
1981	39	40	7	11	42	22
1982	37	31	9	4	16	10
1983	41	42	14	8	10	6

Cases pending as of January 1, 1984: 50

THE BOSTON STOCK EXCHANGE

	Total Cases Received	Total Cases Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	2	2	2	2	2	0
1981	2	2	2	2	0	0
1982	1	1	1	1	1	1
1983	2	2	2	2	2	1

Cases carried over into 1984: 0

CHICAGO BOARD OPTIONS EXCHANGE

	Total Cases Received	Total Cases Concluded Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	44	31	11	11	18	6
1981	41	32	10	8	12	3
1982	50	38	6	6	14	3
1983	75	45	5	4	13	6

Cases carried over into 1984: 16

THE CINCINNATI STOCK EXCHANGE

	Total Cases Received	Total Cases Concluded Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	0	0	0	0	0	0
1981	0	0	0	0	0	0
1982	0	0	0	0	0	0
1983	0	0	0	0	0	0

Cases pending as of January 1, 1984: 0

MIDWEST STOCK EXCHANGE, INC.

	Total Cases Received	Total Cases Concluded Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	2	2	1	0	1	1
1981	2	22	0	0	0	0
1982	1	0	0	0	0	0
1983	2	2	0	0	0	0

Cases pending as of January 1, 1984: 1

MUNICIPAL SECURITIES RULEMAKING BOARD

	Total Cases Received	Total Cases Concluded Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	21	21	7	7	3	2
1981	25	25	5	5	7	4
1982	33	30	7	7	13	6
1983	78	39	17	9	14	5

Cases pending as of January 1, 1984: 52

 NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

	Total Cases Received	Total Cases Concluded Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	318	234	134	113	122	56
1981	422	422	142	177	242	118
1982	606	435	157	139	276	140
1983	768	549	216	147	272	161

Cases pending as of January 1, 1984: 654

NEW YORK STOCK EXCHANGE

	Total Cases Received	Total Cases Concluded Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	367	327	131	110	221	119
1981	477	433	117	134	214	111
1982	558	473	109	113	214	118
1983	713	532	136	122	276	137

Cases pending as of January 1, 1984: 486

THE PACIFIC STOCK EXCHANGE, INCORPORATED

	Total Cases Received	Total Cases Concluded Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	24	28	12	11	4	3
1981	24	20	17	17	9	5
1982	31	21	15	11	10	7
1983	35	29	17	17	23	10

Cases carried over into 1984: 20

PHILADELPHIA STOCK EXCHANGE

	Total Cases Received	Total Cases Concluded Including Settlements	Small Claims Received	Small Claims Concluded	Public Customer Cases Decided	Awards in Favor of Public
1980	7	0	16	4	4	2
1981	10	6	6	3	6	1
1982	23	15	18	11	14	8
1983	17	19	9	11	12	5

Cases carried over into 1984: 6

Id.

Preliminary figures for 1984 indicate a significant aggregate increase over the previous

excessive costs.⁸ Unless arbitration procedures are fair in fact and appearance, however, their present popularity as a means of resolving securities disputes will be greatly diminished.

This Article discusses the history and development of securities arbitration, the availability of arbitration, the enforceability of arbitration agreements, and some jurisdictional and procedural problems inherent in present practices. The Article concludes that the arbitration process must become more centralized and independent, and must include more direct public participation.

I. DEVELOPMENT OF SECURITIES ARBITRATION

Prior to 1976, most SROs had differing rules for the administration of securities arbitration disputes. In June 1976, the Securities and Exchange Commission (SEC or Commission) solicited comments from interested persons on the feasibility of developing a "uniform system of dispute grievance procedures for the adjudication of small claims."⁹ After conducting a public forum at which written and oral comments were received, the SEC's Office of Consumer Affairs issued a report recommending the adoption of procedures for handling investor disputes and the creation of a new entity to administer the system.¹⁰

Before implementing the proposal for a new arbitration forum, the Commission invited further public comment.¹¹ In response to this invitation, several SROs proposed that a securities industry task force be established to consider the development of "a uniform arbitration code and the means for establishing a more efficient, economic and appropriate mechanism for resolving investor disputes involving small sums of money."¹² Pursuant to such suggestion, a Securities Industry Conference on Arbitration (SICA), consisting of representatives of various SROs,¹³ the Securities Industry Association (SIA)¹⁴ and the public,¹⁵

year in the number of security arbitrations filed with the SROs. Dorfman, *A Lynch Mob from Maryland is after Merrill*, N.Y. Sunday News, Oct. 14, 1984, at 51, col. 1. ("On the Big Board, as well as the National Association of Securities Dealers . . . the number of arbitration filings this year is each up a hefty 41%.")

8. See *infra* notes 36-52, and accompanying text.

9. Sec. Exch. Act Release No. 12528 (June 9, 1976), reprinted in 9 SEC Docket 833-35 (March-July 1976).

10. Sec. Exch. Act Release No. 12974 (Nov. 15, 1976), reprinted in 10 SEC Docket 955-56 (July-Dec. 1976).

11. *Id.*

12. Fourth Report, *supra* note 7, at 1.

13. The following SROs were represented: the American, Boston, Cincinnati, Midwest, New York, Pacific and Philadelphia Stock Exchanges, the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board and the National Association of Securities Dealers, Inc. *Id.* at 2.

14. *Id.* The SIA is a trade association for the securities industry.

15. Peter R. Cella, Jr., Esq., Mortimer Goodman, Esq., and the author have served as Public Members of SICA since its creation in 1977. *Id.* In 1983, Justin Klein, Esq. was added as the fourth Public Member of SICA. *Id.*

was established in April 1977.¹⁶

The Commission then invited proposals from SICA to address, inter alia, improved methods for the resolution of investors' small claims.¹⁷ After holding numerous meetings throughout the country, SICA developed a simplified arbitration procedure for resolving customer claims of \$2,500 or less,¹⁸ and issued an informational booklet describing small claims procedures (Small Claims Booklet).¹⁹ Realizing, however, that the development of a small claims procedure was only a first step,²⁰ SICA then developed a comprehensive Uniform Code of Arbitration (Uniform Code of Arbitration or Code)²¹ for the securities industry. The Code established a uniform system of arbitration procedures to cover all claims by investors.²² In addition, SICA prepared an explanatory booklet for prospective claimants (Procedures Booklet or Arbitration Procedures)²³ explaining procedures under the Code. To a great extent, the Code incorporated and harmonized the rules of the various SROs and codified various procedures which the SROs had followed but which were not included in their existing rules. The Code was adopted by the participating SROs during 1979 and 1980.²⁴ Since then, various revisions have been made to both the Code and the Procedures Booklet,²⁵ and SICA has continued "to meet periodically to monitor the performance of the Code in action".²⁶ To date, almost five thousand cases—including small claims—have been filed with the participating SROs since the approval of the Code.²⁷

16. *Id.* at 1-2.

17. Implementation of An Investor Dispute System, [1977-78 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,136, at 87,905 (April 26, 1977) (Sec. Exch. Act Release No. 13470) [hereinafter cited as Investor Dispute System].

18. Fourth Report, *supra* note 7, at 2.

19. See Securities Industry Conference on Arbitration, How to Proceed with the Arbitration of a Small Claim (available in files of *Fordham Law Review*) [hereinafter cited as Small Claims Booklet].

20. Report of the Securities Industry Conference on Arbitration to the Securities and Exchange Commission 7-8 (Nov. 15, 1977) (available in files of *Fordham Law Review*) [hereinafter cited as First Report].

21. See Uniform Code of Arbitration (as amended), reprinted in Fourth Report of the Securities Industry Conference on Arbitration to the Securities and Exchange Commission (Nov. 1984) (Exhibit C) (available in files of *Fordham Law Review*) [hereinafter cited as Uniform Code of Arbitration]. The Small Claims procedure was incorporated into section 2 of the Code. Uniform Code of Arbitration, *supra*, § 2.

22. Fourth Report, *supra* note 7, at 2.

23. See Third Report of the Securities Industry Conference on Arbitration to the Securities and Exchange Commission 5 (Jan. 31, 1980) (available in files of *Fordham Law Review*) [hereinafter cited as Third Report]; Securities Industry Conference on Arbitration, Arbitration Procedures (1980) (available in files of *Fordham Law Review*) [hereinafter cited as Procedures Booklet].

24. Fourth Report, *supra* note 7, at 3.

25. For examples of such amendments, see *infra* notes 41, 59, 64, 252 and accompanying text.

26. Fourth Report, *supra* note 7, at 3. Whether SICA will continue to perform that role in the future is an open question. See *infra* Conclusion.

27. See Fourth Report, *supra* note 7, at Exhibit A—Statistical Report.

II. AVAILABILITY OF ARBITRATION

A. *General Procedures Under The Uniform Code of Arbitration*

The Code establishes a uniform system of arbitration procedures to be used throughout the securities industry for all claims regardless of the dollar amount in question.²⁸ It "provides for [the] arbitration of disputes between customers and securities industry organizations and individuals under the auspices of the participating [SRO] selected by the customer."²⁹ Such submission is generally initiated pursuant to a duly executed and enforceable written agreement³⁰ or upon demand by the customer.³¹ Under the Code, however, the SROs have reserved the right to decline the use of their arbitration facilities "where—having due regard for the purposes of the [relevant SRO] and the intent of [the] Code—such dispute, claim or controversy is not a proper subject matter for arbitration."³² Thus, the arbitration facilities of the participating SROs are generally available only for the "resolution of disputes relating to or arising out of the activities of broker-dealers."³³ Moreover, a controversy is not eligible for submission to arbitration if six or more years³⁴ have elapsed from the date of the event giving rise to the dispute.³⁵

The Code also directs the SRO to appoint a panel of not less than three, nor more than five, impartial arbitrators,³⁶ at least a majority of whom shall *not* be from the securities industry.³⁷ The public customer may, however, request a panel consisting of at least a majority from the securities industry.³⁸ In addition, the Director of Arbitration of the SRO shall determine the individuals who shall serve on a particular arbitration

28. See *infra* notes 63-78 and accompanying text for a description of small claims procedures under the Code.

29. Third Report, *supra* note 23, at 3.

30. Uniform Code of Arbitration, *supra* note 21, § 1(a). See *infra* note 54 and accompanying text.

31. Uniform Code of Arbitration, *supra* note 21, § 1(a).

32. *Id.* § 1(b). For example, an SRO can decline to accept for arbitration a personal injury claim totally unrelated to the securities business.

33. Procedures Booklet, *supra* note 23, at 2.

34. Uniform Code of Arbitration, *supra* note 21, § 4. This six year period may be extended, however, by the tolling provision of the Code, which provides:

Where permitted by law, the time limitation(s) which would otherwise run or accrue for the institution of legal proceedings, shall be tolled when a duly executed Submission Agreement is filed by the Claimant(s). The tolling shall continue for such period as the [SRO] shall retain jurisdiction upon the matter submitted.

Id. § 7(a).

35. *Id.* § 4. See generally Annot., 94 A.L.R. 3d 533 (1979) (discussing how statutes of limitation can bar arbitration).

36. Uniform Code of Arbitration, *supra* note 21, § 8(a)(1). If the matter in controversy is \$100,000 or more, a panel of five arbitrators is mandatory. *Id.* § 8(a)(2); see *id.* § 11. See *infra* note 43 and accompanying text.

37. Uniform Code of Arbitration, *supra* note 21, § 8(a)(1), (2). For a discussion of who such nonindustry arbitrators may be, see *infra* notes 245-55 and accompanying text.

38. Uniform Code of Arbitration, *supra* note 21, § 8(a)(1), (2).

panel and may name the chairperson of each panel.³⁹ The Code further provides that the parties must be informed of the names and affiliations of the arbitrators before the date fixed for the initial hearing.⁴⁰ Each party is given one peremptory challenge,⁴¹ although challenges for cause are unlimited.⁴² Furthermore, to ensure that the parties can make an informed decision as to the neutrality of the arbitrators, the arbitrators are affirmatively obligated to disclose "any circumstances which might preclude such arbitrator from rendering an objective and impartial determination."⁴³ Consistent with arbitration practice generally,⁴⁴ the Code gives wide latitude to arbitrators concerning the materiality, relevance and admissibility of evidence.⁴⁵ At any stage of the proceeding, all parties have the right to representation by counsel.⁴⁶ The Code does not require the SRO's to keep a record of the arbitration proceeding, however, unless requested by the arbitrator or a party.⁴⁷

Although the Code further provides that the arbitrators and counsel shall have subpoena power as provided by law,⁴⁸ it encourages the parties to produce the necessary documents and witnesses "to the fullest extent possible without resort to the issuance of the subpoena process."⁴⁹ Moreover, arbitrators can compel the appearance of any employee or associate of any member or member organization of the SRO conducting the arbitration, "and/or the production of any records in the possession or control of such persons, members or member organizations."⁵⁰ The Code also provides that the "parties shall cooperate in the voluntary exchange of such documents and information"⁵¹ as will serve to expedite the arbi-

39. *Id.* § 8(b). Some SROs permit the arbitrators to pick the chairperson of their panel. *Id.*

40. *Id.* § 9 ("The Director of Arbitration [of the SRO] shall inform the parties of the names and business affiliations of the arbitrators at least eight business days prior to the date fixed for the initial hearing session.").

41. *Id.* § 10. Moreover, SICA has amended the Code so that when there are multiple claimants, respondents and/or third party respondents, there shall be only one peremptory challenge "unless the Director of Arbitration determines that the interests of justice would best be served by awarding additional peremptory challenges." *Id.*

42. *Id.*

43. *Id.* § 11.

44. See Domke, On Commercial Arbitration § 24.02, at 364 (1984) (arbitrators have discretionary power to admit and hear any evidence parties may wish to present, and rulings on admissibility of evidence are not reviewable by courts).

45. Uniform Code of Arbitration, *supra* note 21, § 22.

46. *Id.* § 15.

47. *Id.* § 25. In fact, however, some sort of record is kept by most SROs. If a party asks to have the record transcribed, he must bear the cost. *Id.*

48. *Id.* § 20(a); see, e.g., Ariz. Rev. Stat. Ann. § 12-1507 (1982); Cal. Civ. Proc. Code § 1282.6 (West 1982 & Supp. 1984); Conn. Gen. Stat. § 52-412 (1982 & Supp. 1984); New York Civ. Prac. Law § 7505 (McKinney 1980). For a discussion of the effect of such subpoenas see *infra* note 52.

49. Uniform Code of Arbitration, *supra* note 21, § 20(a).

50. *Id.* § 21. "Unless the arbitrators direct otherwise, the party requesting the appearance of a person or the production of documents . . . shall bear all reasonable costs of such appearance and/or production." *Id.*

51. *Id.* § 20(b).

tration. Extensive pre-trial discovery as practiced in the courts, however, is not available in arbitration proceedings.⁵²

52. Domke, *supra* note 44, § 27.01 at 411. Generally, pre-trial discovery procedures, such as bills of particulars, interrogatories, depositions, and notices to produce documents for inspection, "are intended to eliminate 'trial by ambush'—to focus the dispute by bringing to light the pertinent differences before trial." Goldstein, *Issue of Pretrial Discovery*, N.Y. Times, Jan. 5, 1979, at D4, col. 1; see *Greyhound Lines, Inc. v. Miller*, 402 F.2d 134, 143 (8th Cir. 1968); *Wood v. Todd Shipyards*, 45 F.R.D. 363, 364 (S.D. Tex. 1968); *Ash v. Farwell*, 37 F.R.D. 553, 556 (D. Kan. 1965). Regrettably, however, discovery can be unnecessarily expensive and burdensome, Committee on Arbitration, Ass'n of the Bar of the City of N.Y., *The Use of Discovery in Arbitration* 231, 232 (1978) [hereinafter cited as *The Use of Discovery in Arbitration*]; Ehrenbod, *Cutting Costs Through Interrogatories and Document Requests*, 1 *Litigation* 17, 17 (Spring 1975); Limoni, *The Quantum of Discovery v. the Quality of Justice: More is Less*, 4 *Litigation* 8, 8 (Fall 1977), at times running on for years and involving millions of documents. Goldstein, *supra*, at D4, col. 1; see Federal Judicial Center, *Survey of Literature on Discovery from 1970 to the Present: Expressed Dissatisfactions and Proposed Reform* 49 (1978). See generally Pope, *Rule 34: Controlling the Paper Avalanche*, 7 *Litigation* 28, 28 (Spring 1981) (analysis of cases involving extensive discovery). In short, discovery can "become a stalling tactic, a nuisance, an effort to grind down the other side." Goldstein, *supra*, at D4, col. 1; see Amendments to the Federal Rules of Civil Procedure, 85 F.R.D. 521, 523 (1980) (Powell, J., dissenting); Rosenberg, *Discovery Abuse*, 7 *Litigation* 8, 8 (Spring 1981).

For these reasons, it is not much of a surprise that in most jurisdictions pre-trial discovery is much more limited in an arbitration than in an action at law. Goldberg, *A Lawyer's Guide to Commercial Arbitration* § 3.03, at 40 (2d ed. 1983). This is true "even though the lack of discovery may be fatal to a party's case." *Id.* The rationale supporting the policy of limited discovery is that the "purpose of and methods of procedures in arbitration are to achieve an economical, expedited and fair result Indeed, the desire to contain costs and avoid delay are usually the major reasons why parties elect and agree to arbitrate disputes." *The Use of Discovery in Arbitration, supra*, at 232; see Goldberg, *A Supreme Court Justice Looks at Arbitration*, 20 *Arb. J.* 13, 14 (1965); Willenken, *Discovery in Aid of Arbitration*, 6 *Litigation* 16, 16 (Winter 1980). In addition, arbitrators may be laymen unfamiliar with disclosure proceedings and therefore may be unable to prevent abuse and exercise adequate control. 8 J. Weinstein, H. Korn & A. Miller, *New York Civil Practice* ¶ 7505.06, at 75-129 (1984); see Wolff, *Disclosure Proceedings Opposed*, 18 *Bar. Bull.* 111, 111 (Nov.-Dec. 1960).

In arbitrations, discovery is usually limited to a voluntary disclosure of evidence by the parties and a mandatory disclosure of evidence by subpoena issued by the arbitrators or, in some instances, the attorney of record. *The Use of Discovery in Arbitration, supra*, at 232. The state statutes that grant arbitrators subpoena power, see *supra* note 48, do not confer on the arbitrator the authority to use discovery devices. 8 J. Weinstein, H. Korn & A. Miller, *supra*, ¶ 7505.06, at 75-128. Rather, the statutes merely permit the arbitrator to issue a subpoena ordering the parties to produce evidence at the arbitration hearing itself "in order to relieve [the arbitrator] of the necessity of asking a court to issue the subpoena." *Id.* ¶ 7505.06, at 75-129. Generally, however, counsels for the parties can agree on a procedure for reviewing the subpoenaed documents in advance of the hearing, thereby saving the time of both the parties and the arbitrators at the hearing. *The Use of Discovery in Arbitration, supra*, at 235; see Uniform Code of Arbitration, *supra* note 21, § 20. More intensive pre-arbitration discovery may be permissible if the parties so provide by agreement, R. Haydock & D. Herr, *Discovery Practice* § 10.3.2, at 487 (1982); Willenken, *supra*, at 18, or if the "rules under which the arbitration is conducted permit the arbitrators to settle the procedures which govern." *The Use of Discovery in Arbitration, supra*, at 232.

Although a court may have the power to permit pre-arbitration discovery, R. Haydock & D. Herr, *supra*, § 10.3.2, at 488; Willenken, *supra*, at 16; Willenken, *The Often Over-*

The Code also sets out provisions for pleadings and amendments thereto.⁵³ A claimant institutes a proceeding by filing three executed copies of both the Submission Agreement and the Statement of Claim of the controversy in dispute.⁵⁴ The Statement of Claim should specify the relevant facts and remedies sought.⁵⁵ The respondent has twenty business days from receipt to submit an executed copy of the Submission Agreement and a copy of his Answer,⁵⁶ which must set forth all available defenses to the Statement of Claim.⁵⁷

Although this procedure may seem adequate on its face, problems have occasionally occurred in practice when the Answer has consisted solely of a general denial. In such a situation, the claimant, stripped of the normal discovery procedures available in judicial litigation,⁵⁸ may be

looked Use of Discovery in Aid of Arbitration and the Spread of the New York Rule to Federal Common Law, 35 Bus. Law 173, 173-74 (Nov. 1979), this power has been used sparingly and only in extreme circumstances. R. Haydock & D. Herr, *supra*, § 10.3.2, at 488; 8 J. Weinstein, H. Korn & A. Miller, *supra*, ¶ 7505.06, at 75-130; Note, *Arbitration and Award—Discovery—Court May Permit Discovery on the Merits When It Will Not Delay Arbitration*, 44 Cinn. L. Rev. 151, 152 (1975). Indeed, the New York Court of Appeals in *DeSapio v. Kohlmeyer*, 35 N.Y.2d 402, 321 N.E.2d 770, 362 N.Y.S.2d 843 (1974), held that a defendant had waived his right to arbitration as provided in the agreement because he had procured a pre-trial deposition of the plaintiff in a judicial action. *Id.* at 406, 321 N.E.2d at 773, 362 N.Y.S.2d at 847. The court stated that the procurement of the plaintiff's deposition constituted "an election between the forums available for the resolution of the dispute." *Id.*

Some commentators have proposed that arbitrators have the discretion to:

direct that documents called for by subpoena be made available for review by the adverse party in advance of a hearing. In the event that the subpoenaed party objects to the scope of the subpoena or the production of any of the documents called for, the Arbitrator shall rule on such objection prior to directing that the documents be made available for review.

The Use of Discovery in Arbitration, *supra*, at 231. The commentators maintain that such a proposal will help save the time of the parties and the arbitrators and will help avoid those situations where the parties cannot agree on pre-hearing document inspection. *Id.* at 235. SICA, however, rejected a similar suggestion because of the potential for abuses causing excessive costs and delays. Instead, § 20 of the Code simply provides:

(a) The arbitrators and any counsel of record to the proceedings shall have the power of the subpoena process as provided by law. However, the parties shall produce witnesses and present proofs to the fullest extent possible without resort to the issuance of the subpoena process.

(b) Prior to the first hearing session, the parties shall cooperate in the voluntary exchange of such documents and information as will serve to expedite the arbitration. If the parties agree, they may also submit additional documents to the Director of Arbitration for forwarding to the arbitrators.

Uniform Code of Arbitration, *supra* note 21, § 20.

53. Uniform Code of Arbitration, *supra* note 21, §§ 13(a) & (b), 27. Section 13 of the Code also sets forth a provision for joinder and consolidation. *Id.* § 13(c).

54. *Id.* § 13(a). The Submission Agreement is a document filed with the SRO whereby the parties agree to submit their controversy to arbitration. See First Report, *supra* note 20, at Exhibit B for an illustration of a Submission Agreement.

55. Uniform Code of Arbitration, *supra* note 21, § 13(a).

56. *Id.* § 13(b).

57. *Id.*

58. See *supra* note 52 and accompanying text.

unaware of the respondent's defenses and consequently may be unsure of what he must prove at the hearing. To avoid this situation, SICA recently approved an amendment to the Code⁵⁹ that requires the defendant to specify in his answer all available defenses and relevant facts on which he will rely at the hearing.⁶⁰ In addition, if the defendant pleads a general denial and the claimant makes a written objection to the Director of Arbitration prior to the hearing, the arbitrators may bar the defendant from presenting any facts or defenses at the hearing.⁶¹ Finally, if the "defendant fails to specify all available defenses and relevant facts in [his] answer . . . [the defendant] may, upon objection by the [claimant] . . . be barred from presenting the facts or defenses not included in such party's answer at the hearing."⁶²

B. *Small Claims Procedure*

The provisions governing Small Claims are found in section 2 of the Code.⁶³ Under that section, customer disputes involving \$2,500 or less⁶⁴ "shall, upon demand of the customer(s) or by written consent of the parties"⁶⁵ be submitted for resolution to a single arbitrator⁶⁶ who is

59. The amendment was passed after much debate within SICA. Some members maintained that respondents who had used general denials to gain a tactical pleading advantage could be adequately controlled under the arbitrators' already broad powers to discipline abusive parties. SICA concluded, however, that more specific guidance was needed to solve the problem.

60. The revised section provides:

(b) Answer-Defenses, Counterclaims and/or Crossclaims

(1) The Respondent(s) shall within twenty (20) business days from receipt of service file with the Director of Arbitration one (1) executed Submission Agreement and one (1) copy of the Respondent's(s') Answer. The Answer shall specify all available defenses and relevant facts that will be relied upon at hearing and [may set forth any related counterclaim the Respondent] may have against the Claimant and any third party claim against any other party or person upon any existing dispute, claim or controversy to arbitration under this Code.

Fourth Report, *supra* note 7, at C-5 (Uniform Code of Arbitration § 13(b)(1))

61. The Code further provides:

(2) (i) A Respondent, Responding Claimant, Cross-Claimant or Third Party Respondent who pleads only a general denial as an answer may, upon written objection by the adversary party before the hearing to the Director of Arbitration, in the discretion of the arbitrators, be barred from presenting any facts or defenses at the time of the hearing.

Uniform Code of Arbitration, *supra* note 21, § 13(b)(2)(1).

62. *Id.*

63. Uniform Code of Arbitration, *supra* note 21, § 2.

64. *Id.* § 2(a). The ceiling for Small Claims disputes has been raised to \$5,000. See Fourth Report, *supra* note 7, at 3. The Revisions to the Code have already been filed or will be filed shortly by the various SROs with the SEC. *Id.*

65. Uniform Code of Arbitration, *supra* note 21, § 2(a).

66. *Id.* § 2(f). Upon the request of the single arbitrator, the SRO can appoint two additional arbitrators to the panel to decide the matter in controversy, *id.* § 2(i), in which case the majority will be public arbitrators, *id.* § 2(j).

knowledgeable in the securities industry.⁶⁷ "The arbitrator will decide the dispute on the basis of the documents submitted, unless the customer requests a hearing and the arbitrator believes that a hearing is necessary or appropriate."⁶⁸ If a hearing is to be held, the Arbitration Director of the SRO with which the claim has been filed will choose the location,⁶⁹ giving due consideration to the residence of the claimant and other relevant factors.⁷⁰ Unless otherwise provided, the general arbitration rules⁷¹ of the SRO involved will be followed at the Small Claims proceeding.⁷² In addition, "certain matters of an internal administrative nature [are left] to the discretion of the sponsoring SRO."⁷³

The Small Claims procedure was designed to provide a fair, easy and inexpensive arbitration system. It allows a public customer to initiate a proceeding by filing a simple explanation of the basis of the claim,⁷⁴ and by paying a small fee as a deposit for costs.⁷⁵ The deposit is refunded if the matter is resolved without the use of an arbitrator.⁷⁶ Otherwise the refund of the deposit is within the arbitrator's discretion.⁷⁷ Since the inception of the Small Claims procedure, nearly 1500 small claims have been filed with the participating SROs.⁷⁸

C. Finality of the Award

The scope of judicial review of an arbitration award is very limited.⁷⁹ "If the award is within the submission, and contains the honest decision of the arbitrators, after a full and fair hearing of the parties, a court of equity will not set it aside for error, either in law or fact."⁸⁰ In fact, the typical grounds for vacating an arbitration award are surprisingly uniform throughout the United States,⁸¹ namely:

- (1) There was an undisclosed relationship between an arbitrator

67. *Id.* § 2(f). "In appointing . . . such person reasonable efforts will be made to select an arbitrator from the public sector." First Report, *supra* note 20, at 4.

68. Uniform Code of Arbitration, *supra* note 21, § 2(f); First Report, *supra* note 20, at 4.

69. Uniform Code of Arbitration, *supra* note 21, § 2(f).

70. First Report, *supra* note 20, at 5.

71. See *supra* notes 28-62 and accompanying text.

72. Uniform Code of Arbitration, *supra* note 21, § 2(f).

73. First Report, *supra* note 20, at 7.

74. *Id.* at 5.

75. Uniform Code of Arbitration, *supra* note 21, § 2(c). The present fee is \$15. *Id.* With the increase in the jurisdictional limit of Small Claims from \$2,500 to \$5,000, however, see *supra* note 64, that fee will rise to \$25 if the controversy is more than \$1,000, but less than \$2,500, and \$100 if the controversy is worth more than \$2,500 but less than \$5,000. Fourth Report, *supra* note 7, at 3.

76. See Small Claims Booklet, *supra* note 19, at 3.

77. See Uniform Code of Arbitration, *supra* note 21, § 2(c).

78. Fourth Report, *supra* note 7, at Exhibit A—Statistical Report.

79. Goldberg, *supra* note 52, § 5.03, at 61; see Domke, *supra* note 44, § 33.02, at 465-67.

80. Burchell v. Marsh, 58 U.S. 344, 349 (1854).

81. Goldberg, *supra* note 52, § 5.04, at 62.

and a party or his counsel affecting the arbitrator's impartiality or appearance of impartiality.

(2) An arbitrator was corrupt.

(3) The arbitrators did not schedule or conduct the hearing in a fair and judicious manner.

(4) The arbitrators granted relief that they were not authorized to grant under the contract pursuant to which the arbitration was held.⁸²

Although SICA did consider broadening the scope of review of securities arbitration awards,⁸³ the proposal was rejected as inimical to the simplicity and brevity of arbitration procedures.⁸⁴

82. *Id.* at § 5.04 at 63; see Annot. 22 A.L.R. 4th 366 (1983). When an arbitration involves a dispute arising from an interstate commerce transaction, it is governed by § 10 of the United States Arbitration Act, 9 U.S.C. § 10 (1982), which provides:

In either of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration—

(a) Where the award was procured by corruption, fraud, or undue means.

(b) Where there was evident partiality or corruption in the arbitrators, or either of them.

(c) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any misbehavior by which the rights of any party have been prejudiced.

(d) Where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.

(e) Where an award is vacated and the time within which the agreement required the award to be made has not expired, the court may, in its discretion, direct a rehearing by the arbitrators.

9 U.S.C. § 10 (1982).

83. See Minority Report of Mortimer Goodman, Public Member Security Industry Conference on Arbitration, In Respect of a Right of Review of an Arbitration Award (Filed with SEC on Dec. 15, 1977) (available in files of *Fordham Law Review*). Under this proposal, any party to an arbitration would have the right to seek review of the award before a newly appointed three member Review Panel of Arbitrators. *Id.* at Exhibit A. The costs of the arbitration would be assessed against the party moving for review, unless the Review Panel reversed the award and sent it back for a new hearing or modified it. *Id.* at 3. A system of alternative dispute resolution in New York similarly provides that a litigant, after disposition of a case, "may seek a court trial *de novo* . . . [and] unless he receives a more favorable result on the trial, he shall pay costs to the other party." Greenwald, *Alternatives to Court Resolution of Disputes: Report of NYSBA's Special Committee*, N.Y.S.B. J., Oct. 1984, at 36-37 (footnote omitted).

84. Broadening the scope of arbitration review would undoubtedly result in increased expenses, not only because of the obvious costs associated with an appeal, but also because more detailed records of the arbitration would have to be kept. Broad review would also prevent speedy resolution of the dispute, because the arbitrators' award could not be collected while an appeal was pending. Section 29(b) of the Code simply provides: "Unless the law directs otherwise, all awards rendered pursuant to this Code shall be deemed final and not subject to review or appeal." Uniform Code of Arbitration, *supra* note 21, § 29(b).

III. ENFORCEABILITY OF CUSTOMER'S PRE-DISPUTE AGREEMENT TO ARBITRATE

Under present law, an investor may agree to submit to arbitration an existing controversy with a broker-dealer.⁸⁵ Securities investors are often required, as a condition to opening an account with a broker-dealer, to sign an agreement to arbitrate future disputes.⁸⁶ Under the United States Arbitration Act (federal Arbitration Act or Arbitration Act),⁸⁷ agreements to arbitrate future disputes are, in general, specifically enforceable.⁸⁸ The Arbitration Act also provides for a stay of litigation pending the arbitration.⁸⁹ Similarly, most states recognize valid arbitration agreements, and have enacted statutes setting forth procedures to implement them.⁹⁰

85. *Malena v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,492, at 98,449 (E.D.N.Y. April 18, 1984); see *Tullis v. Kohlmeyer & Co.*, 551 F.2d 632, 637 (5th Cir. 1977); Krause, *Securities Litigation: The Unsolved Problem of Predispute Arbitration Agreements for Pendent Claims*, 29 De Paul L.Rev. 693, 694 (1980).

86. The standard arbitration clause "authorizes the customer to elect the arbitration forum from a list of several organizations. If the customer does not elect the forum within five days after receipt from the broker-dealer of a notification requesting such election, the broker-dealer becomes authorized to make the election." Sec. Exch. Act Release No. 15984 n.4, (July 2, 1979), reprinted in 17 SEC Docket 1167, 1169 n.4 (June-Aug. 1979) [hereinafter cited as Securities Release]. The extent to which customers are, as a practical matter, "required" to sign what can basically be described as a typical industry-wide agreement containing a pre-dispute arbitration clause is a critical question. This is particularly so if "the customer may be precluded from doing business with the broker-dealer if he or she refuses to sign the agreement or the broker-dealer is unwilling to accept any modification of its terms." *Id.* at 1169. It would appear that such agreements are largely in effect with respect to margin, option and commodity accounts, and, to a lesser degree, cash accounts. See Stansbury & Klein, *The Arbitration of Investor-Broker Disputes: A Summary of Development*, 35 Arb. J. 30, 32 (1980). As to the presently prevailing practice in opening new accounts, however, the author's "horseback" survey indicates that customers' agreements containing pre-dispute arbitration clauses are still generally required in opening margin, option and commodity accounts, but not necessarily for cash accounts. This difference probably stems from the fact that the former usually involve an extension of some form of credit by the firm to the customer, thus increasing the need for speedy resolution of problems through arbitration.

87. 9 U.S.C. §§ 1-14 (1982).

88. Section 2 of the Act provides: "A written provision in . . . a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." *Id.* § 2 (emphasis added). Because the Federal Arbitration Act applies to claims arising from transactions involving interstate commerce, *id.*, and because securities dealings usually involve such transactions, state securities claims, as well as those arising under the federal securities laws, are usually arbitrable. See *infra* notes 107-12 and accompanying text.

89. See 9 U.S.C. § 3 (1982).

90. See, e.g., *Ariz. Rev. Stat. Ann.* §§ 12-501 to -518 (1982 & Supp. 1983); *Cal. Civ. Proc. Code* §§ 1280 to -88.8 (West 1982 & West Supp. 1984); *Conn. Gen. Stat.* §§ 52-408 to -424 (1960 & Supp. 1984); *Del. Code Ann.* tit. 10, §§ 5701-5725 (1975 & Supp. 1982); *N. Y. Civ. Prac. Law* §§ 7501-7514 (McKinney 1980 & Supp. 1983). Recently, the Supreme Court stated that the Federal Arbitration Act, 9 U.S.C. §§ 1-14 (1982), creates a substantive rule that is applicable in state as well as federal courts. *Southland Corp. v.*

A. *The Wilko Exemption*

Section 14 of the the Securities Act of 1933, (Securities Act or 1933 Act)⁹¹ provides that "[any] condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."⁹² In view of this nonwaiver provision, what effect would a pre-dispute arbitration clause—such as those found in most broker-dealers' customer agreements—have upon a claim arising out of the Securities Act?⁹³ The Supreme Court faced this issue in *Wilko v. Swan*,⁹⁴ which case involved a claim by a customer against a securities brokerage firm to recover damages under section 12(2) of the Securities Act.⁹⁵ The brokerage firm moved, pursuant to section 3 of the Arbitration Act,⁹⁶ to stay the trial of the action until an arbitration was held according to the terms of a pre-dispute arbitration clause contained in margin agreements between the parties.⁹⁷ The lower court held that the Securities Act did not prohibit an agreement to refer future controversies to arbitration.⁹⁸ The Supreme Court reversed, based on the purposes of the federal Securities

Keating, 104 S. Ct. 852, 860-61 (1984); see *Prima Paint v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 405 (1967). The Court in *Southland* further stated that Congress "intended to foreclose state legislative attempts to undercut the enforceability of arbitration agreements." *Southland*, 104 S. Ct. at 861; see *Moses H. Cone Memorial Hosp. v. Mercury Constr. Co.*, 103 S. Ct. 927, 941 (1983); see also Committee on Arbitration of the Ass'n of the Bar of the City of New York, *An Outline of Procedure under New York Arbitration Law* 15-16 (Dec. 1970) (discussion of whether Congress' intent in passing the Federal Arbitration Act was to create a national substantive law that is applicable to states).

91. 15 U.S.C. § 77n (1982).

92. *Id.*

93. The Securities Act of 1933 provides for civil liability. 15 U.S.C. §§ 77k, 77l, 77o (1982). The 1933 Act is concerned primarily with the initial distribution of securities, and requires full and fair disclosure of the character of the securities sold to the public. See Katsoris, *Accountants' Third Party Liability—How Far Do We Go?* 36 Fordham L. Rev. 191, 208-09 (1967).

94. 346 U.S. 427 (1953).

95. *Wilko*, 346 U.S. at 428. Section 12 of the Securities Act provides:

Any person who . . . (2) offers or sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

15 U.S.C. § 77l (1982) (special rights provision).

96. 9 U.S.C. § 3 (1982).

97. *Wilko v. Swan*, 201 F.2d 430 (2d Cir.), *rev'd*, 346 U.S. 427 (1953).

98. *Id.* at 445.

and Arbitration Acts.⁹⁹

The Court noted that the Securities Act was designed to protect investors from fraud by requiring full disclosure on the part of the dealer.¹⁰⁰ In order to effectuate this policy, Congress in section 12 specifically gave investors a "special right to recover for misrepresentation which differs substantially from the common-law action in that the seller is made to assume the burden of proving lack of scienter."¹⁰¹ The Court further noted that an investor could not waive this special right,¹⁰² and that section 22 of the 1933 Act¹⁰³ specifically affords to the plaintiff national service of process and a broad choice of forum by making the right enforceable by the investor "in any court of competent jurisdiction—federal or state."¹⁰⁴ The Court then noted that the essential purpose of the Arbitration Act was—in contrast to the Securities Act's purpose of providing a judicial forum for the resolution of securities disputes—to avoid the delay and expense of litigation,¹⁰⁵ whenever possible, in controversies involving statutes as well as case law.¹⁰⁶

Faced with these two conflicting policies, the Court concluded that although the enforcement of pre-dispute arbitration agreements might be economically advantageous,¹⁰⁷ Congress' desire to protect investors would be more effectively served by holding invalid any pre-dispute arbitration agreements relating to issues arising under the Securities Act.¹⁰⁸ In effect, the Court in *Wilko* concluded that the nonwaiver provision of section 14 of the Securities Act,¹⁰⁹ in conjunction with the special rights provision of section 12¹¹⁰ and the special process and forum provision of section 22,¹¹¹ implicitly repealed the Arbitration Act with regard to security claims arising under the 1933 Act.¹¹²

99. *Wilko v. Swan*, 346 U.S. at 431-38.

100. *Id.* at 431.

101. *Id.*; see 15 U.S.C. § 77I (1982).

102. *Wilko v. Swan*, 346 U.S. at 434.

103. 15 U.S.C. § 77v(a) (1982).

104. *Wilko v. Swan*, 346 U.S. at 431

Section 22 provides:

Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found No case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States.

15 U.S.C. § 77v(a) (1982).

105. *Wilko v. Swan*, 346 U.S. at 431.

106. *Id.* at 432.

107. *Id.* at 438.

108. *Id.*

109. 15 U.S.C. § 77n (1982). See *supra* notes 92, 102 and accompanying text.

110. 15 U.S.C. § 77I (1982). See *supra* notes 101-2 and accompanying text.

111. 15 U.S.C. § 77v(a) (1982). See *supra* note 104 and accompanying text.

112. *Wilko v. Swan*, 346 U.S. at 438.

Thus, *Wilko* holds that a member firm may not bind a customer to arbitration to the exclusion of his private remedies under section 12(2) of the Securities Act.¹¹³ Although *Wilko* does not prohibit such an arrangement, it renders it unenforceable when a member firm tries to interpose it as a defense to a suit under the 1933 Act.¹¹⁴ Courts generally will not apply the *Wilko* restraint, however, when it is clear that the parties are knowledgeable persons—for example, a sophisticated investor and a broker-dealer—and that the arbitration agreement was the result of an arm's length transaction.¹¹⁵

Nothing that has been said about pre-dispute arbitration clauses, however, prevents an investor from consenting to submit an existing controversy with a broker-dealer to arbitration.¹¹⁶ Moreover, the limitation on pre-dispute arbitration clauses in securities disputes does not extend to State claims which are not based upon federal securities law.¹¹⁷ Indeed, "the arbitrability of claims arising under state statutory or common law is determined solely by reference to either state arbitration law or the Federal Arbitration Act."¹¹⁸

113. *Id.*

114. The caption appearing in the front of SICA's Procedures Booklet advises a customer that even though he signed an agreement containing a provision to arbitrate any future controversies arising under the agreement, *Wilko* establishes that he cannot "be compelled to arbitrate a claim arising under certain federal securities acts." Procedures Booklet, *supra* note 23, at i. In other words, while a pre-dispute clause may still be included in a broker-customer agreement, it may be of no effect when a dispute arises under the federal securities law.

115. *Alco Standard Corp. v. Benalal*, 345 F. Supp. 14, 24 (E.D. Pa. 1972); *GCA Corp. v. Coler*, [1971-72 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,339 at 91, 815 (S.D.N.Y. Jan. 13, 1975); Peloso, *Agreements to Arbitrate*, 13 Rev. Sec. Reg. 943, 946 (1980); see Krause, *supra* note 85, at 703. It is also suggested that under these circumstances (sophisticated investor/arm's length transaction) the pre-dispute arbitration clause should still be enforceable, despite the doctrine of adhesion. See *infra* notes 213-237 and accompanying text. In addition, section 28b of the Securities and Exchange Act specifically excepts member-to-member controversies from the nonwaiver provision of § 29(a) of that Act. 15 U.S.C. § 78bb(b) (1982). One commentator has suggested that the presence of § 28(b) in the Exchange Act indicates the Congressional view that members of national securities exchanges are presumptively sophisticated and do not need the protection of the Securities and Exchange Act. Peloso, *supra*, at 947. There is no comparable exception in the nonwaiver provision of the Securities Act. The courts, however, have reached a similar conclusion in refusing to extend the *Wilko* doctrine to member-to-member controversies arising under the 1933 Act. See *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766, 772-73 (S.D.N.Y. 1968); *Isaacson v. Hayden, Stone Inc.*, 319 F. Supp. 929, 930 (S.D.N.Y. 1970); Peloso, *supra* at 947-48.

116. Recently a New York District Court stated that "[t]he principle that emerges from the cases evaluating the validity of arbitration clauses is that, while a waiver *in futuro* will not be permitted under *Wilko*, an agreement to arbitrate an existing dispute made when a party has full knowledge of the facts therein will be excepted from the *Wilko* doctrine." *Malena v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,492 at 98,449 (E.D.N.Y. Apr. 18, 1984); see *Tullis v. Kohlmeyer & Co.*, 551 F.2d 632, 637 (5th Cir. 1977).

117. See Krause, *supra* note 85, at 694. See *supra* notes 97-112 and accompanying text.

118. Krause *supra* note 85, at 694-95.

1. *Wilko* Warning

Although the *Wilko* exemption is well established, the SEC has questioned the extent to which the public is aware of its protection. Thus, in 1979, the SEC issued a release that criticized the continued use of arbitration agreements that purported to bind customers to arbitrate all future disputes with broker-dealers.¹¹⁹ The concern of the Commission was that customers agreeing to such clauses¹²⁰ might be unaware of their right under *Wilko* to a judicial forum for the resolution of claims arising under the federal securities laws.¹²¹ Indeed, it cautioned that "[r]equiring the signing of an arbitration agreement without adequate disclosure as to its meaning and effect violates standards of fair dealing with customers and constitutes conduct that is inconsistent with just and equitable principles of trade."¹²² Although the issue of pre-dispute arbitration clauses was raised in SICA discussions, it was outside the limited scope of SICA's assignment.¹²³ In response to the SEC's concerns SICA did, however, preface its Procedures Booklet with the following highlighted notation:

The Supreme Court, in the case of *Wilko v. Swan*, . . . and other Federal Courts have held that a customer of a broker-dealer could not be compelled to arbitrate a claim arising under certain federal securities acts, even though the customer had signed an agreement with the broker-dealer to arbitrate future controversies. If you have signed such a pre-dispute arbitration agreement, you may wish to consult with counsel before proceeding with arbitration.¹²⁴

119. Securities Release, *supra* note 86, at 1169 & n.4.

120. See *supra* note 86.

121. Securities Release, *supra* note 86, at 1167.

122. *Id.* at 1169.

123. SICA was never intended, and was never given any authority, to discipline the conduct of broker-dealers or dictate their conduct. Its sole purpose was to prepare and monitor a Code of Arbitration. Indeed, in a separate dissenting statement to the Securities Release, Commissioner Karmel reasoned:

I object to the issuance of the Commission's release because I believe it improperly casts doubt on the efficacy and fairness of arbitration and thus undermines the valuable work of the Securities Industry Conference on Arbitration ("SICA"). Further, I do not believe that there is sufficient evidence of overreaching of customers by broker-dealers using arbitration clauses in standard customer agreements to justify the issuance of the release. To the contrary, arbitration is an effective and worthwhile alternative to litigation for resolving disputes which reduces the costs to both the customer and the broker-dealer. In my opinion the use of arbitration clauses in customer agreements does not violate or raise questions under the anti-fraud provisions of the federal securities laws. To the extent the Commission considers changes in such clauses necessary or appropriate to comport with just and equitable principles of trade, requested changes should have been directed to SICA or appropriate industry self-regulatory organizations.

Securities Release, *supra* note 86, at 1170 (Karmel, Commissioner, dissenting).

124. Procedures Booklet, *supra* note 23, at i. A warning to the customer is a prerequisite to the enforceability of a predispute arbitration agreement under the Commodity Exchange Act, 7 U.S.C. §§ 7-26 (1982). The agreement is enforceable if:

Not satisfied with the progress of the broker-dealers in amending existing or future customers' agreements to include some sort of a *Wilko* warning regarding arbitration,¹²⁵ the SEC then proposed Rule 15c2-2,¹²⁶ which provides, in part, that it

shall be a fraudulent, manipulative or deceptive act or practice for a broker or dealer to enter into an agreement with any customer which purports to bind the customer to the arbitration of future disputes between them arising under the federal securities laws, [unless such agreement discloses that:] '[a]rbitration cannot be compelled with respect to disputes arising under the federal securities laws'.¹²⁷

Despite severe criticism,¹²⁸ this rule became effective on December 31, 1983.¹²⁹

2. *Wilko* Application

Although the Court in *Wilko* was concerned only with the arbitrability of claims brought under section 12(2) of the 1933 Act,¹³⁰ courts have subsequently held that claims based on violations of sections 5 and 17 of the 1933 Act may also be nonarbitrable.¹³¹ Moreover, it is generally contended that the *Wilko* prohibition also extends to claims based on violation of the Securities Exchange Act of 1934 (Exchange Act or 1934

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- a. executing the agreement is not essential to access to the market;
 - b. customer . . . separately signs the arbitration clause or agreement; and,
 - c. customer is given a warning, in bold face type, that he is surrendering certain rights to assert his claim in court.

17 C.F.R. § 180.3(b)(1), (2), (6) (1984).

125. Precipitating the release was the SEC's concern that, despite the Commissioner's advice, broker-dealers and security industry organizations had failed to modify arbitration clauses in customer agreements to reflect the *Wilko* ruling. Securities Release, *supra* note 86, at 1167 n.7.

126. Sec. Exch. Act Release No. 19813 (May 26, 1983), *reprinted in* 27 SEC Docket 1260 (Feb.-June 1983).

127. *Id.* at 1263. The rule was adopted in Sec. Exch. Act Release No. 20397 (Dec. 28, 1983), 48 Fed. Reg. 53404 (1983) (to be codified at 17 C.F.R. § 240.15c2-2); 3 Fed. Sec. L. Rep. (CCH) ¶ 26,916, at 20,173-2 (1983).

128. See Karmel, *Securities Regulation*, N.Y.L.J., Oct. 20, 1983, at 1, col. 1.

129. 48 Fed. Reg. 53404 (1983) (to be codified at 17 C.F.R. § 240.15c2-2); *see* 3 Fed. Sec. L. Rep. (CCH) ¶ 26,916 at 20,173-2 (1983).

130. See *supra* notes 94-108 and accompanying text.

131. Section 5 of the Securities Act prohibits the use of the mails or any interstate commerce to sell or deliver after sale any security that has not met the registration, filing and prospectus requirements of the Act. 15 U.S.C. § 77e (1982). Section 17 prohibits the use of interstate commerce for the purpose of selling or offering for sale fraudulent securities. 15 U.S.C. § 77 q (1982); *see* Laupheimer v. McDonnell & Co., 500 F.2d 21, 25 (2d Cir. 1974) (section 5 claims are nonarbitrable); Maheu v. Reynolds & Co., 282 F. Supp. 423, 426 (S.D.N.Y. 1968) (same); Davend Corp. v. Michael, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,540, at 99,730 (S.D.N.Y. Apr. 14, 1976) (section 17 claims are nonarbitrable); Frier Indus., Inc. v. Glickman, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,845, at 96,848 (S.D.N.Y. Oct. 22, 1974) (same); Cohen v. Franchard Corp., [1970-71 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,810, at 90,048 (S.D.N.Y. Sept. 23, 1970) (same).

Act)¹³² when the claim does not involve a member-to-member controversy.¹³³

It is often difficult, however, to determine whether a claim arises out of the federal securities laws,¹³⁴ particularly if it is based upon relief implied by section 10(b) of the Exchange Act.¹³⁵ For example, one court has stated that:

[if the] plaintiffs' claim is nothing more than a garden-variety customer's suit against a broker for breach of contract, [it] cannot be bootstrapped into an alleged violation of § 10(b) of the Exchange Act, or Rule 10b-5, in the absence of allegation of facts amounting to *scienter*, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud.¹³⁶

132. 15 U.S.C. § 78 (1982).

133. See *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 835 (7th Cir. 1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536 (2d Cir.), *cert. denied*, 429 U.S. 1010 (1976); *Laupheimer v. McDonnell & Co.*, 500 F.2d 21, 26 (2d Cir. 1974); *Reader v. Hirsch & Co.*, 197 F. Supp. 111, 115 (S.D.N.Y. 1961); Krause, *supra* note 85, at 704. Liability under the Exchange Act is generally founded on § 18, 15 U.S.C. § 78r (1982), and the implied provisions of § 10(b), 15 U.S.C. § 78j(b) (1982), and the Securities and Exchange Commission Rule 10b-5, 17 C.F.R. § 240 (1984). Most 1934 Act investor claims against brokers, however, involve § 10(b) of the Act. Bell & Fitzgerald, *Mixed Arbitrable/Nonarbitrable Disputes*, 16 Rev. Sec. Reg. 849, 851-52 (1983). Unlike the Securities Act, which is concerned primarily with the initial distribution of securities, see *supra* note 93, the Exchange Act deals principally with post-distribution trading. Katsoris, *supra* note 93, at 214.

134. See Peloso, *supra* note 115, at 949.

135. Section 10(b) of the Exchange Act states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange-

...

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j (1982). Pursuant to this authority, the SEC promulgated rule 10b-5, which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. §§ 240.10b-5 (1984). Although neither § 10(b) nor rule 10b-5 explicitly provides for any civil liabilities, it is well established that by making the conduct unlawful, § 10(b) impliedly creates a civil remedy. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983); L. Loss, *Security Regulations* 1763-97 (1961).

136. *Snemto v. Shearson, Hammill & Co.*, 448 F.2d 442, 445 (2d Cir. 1971) (emphasis

Thus, *Wilko* would not apply to a simple contract dispute with a broker-dealer, because the claim does not arise under the securities laws. Indeed the Supreme Court in *Scherk v. Alberto-Culver Co.*,¹³⁷ suggested in dictum that the *Wilko* prohibition did not extend to a case brought under section 10(b) of the Exchange Act or Rule 10b-5.¹³⁸ In reaching this conclusion, the Court stated that *Wilko* should not extend to 10b-5 claims because section 12 of the 1933 Act provides "a defrauded purchaser with [a] 'special right' of a private remedy for civil liability . . . [whereas] [t]here is no statutory counterpart of § 12(2) in the Securities Exchange Act of 1934, and neither § 10(b) of that Act nor Rule 10b-5 speaks of a private remedy to redress violations of the kind alleged here."¹³⁹ The Court noted that although federal case law had established that section 10(b) and rule 10b-5 create an implied private cause of action,¹⁴⁰ the "Act itself does not establish the 'special right' that the Court in *Wilko* found significant."¹⁴¹

Lower courts, however, have rejected the *Scherk* suggestion that the *Wilko* doctrine may not apply to implied causes of action under section 10(b) and rule 10b-5 of the 1934 Act.¹⁴² Indeed, several courts have suggested that *Scherk* merely carves "out a narrow exception to the *Wilko* holding, and is applicable only to international transactions."¹⁴³ In rejecting the Supreme Court's suggestion that *Wilko* should be limited to claims brought under the Securities Act,¹⁴⁴ lower courts have neglected

in original); see *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200-01 (1976). See *infra* note 202 and accompanying text.

137. 417 U.S. 506 (1974).

138. *Id.* at 513-14. The Court in *Scherk* found a pre-dispute arbitration clause to be enforceable, despite *Wilko*, in a dispute involving a 10b-5 claim. *Id.* The Court did not, however, explicitly hold that *Wilko* did not apply to 10b-5 claims. Rather, the Court held that the pre-dispute arbitration agreement was enforceable because of the crucial differences between the relationship of the parties in *Wilko* and that of the parties in *Scherk*. *Id.* at 515. The Court emphasized that in *Wilko* the arbitration agreement was between a customer and a broker, whereas in *Scherk* the agreement was part of a contract between parties to an international transaction for the sale of business entities. *Id.* This difference was significant because if the arbitration agreement, which provided in advance for a specific forum for resolving disputes, was not enforced, the parties would be faced with many uncertainties because of the various conflict of law rules that might be applied. *Id.* at 515-16.

139. *Id.* at 513.

140. *Id.*

141. *Id.* at 514.

142. See *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1030 (6th Cir. 1979); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823, 827-29 (10th Cir. 1978); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 835 (7th Cir. 1977); *Ayres v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 538 F.2d 532, 536 & n.12 (3d Cir. 1976); *Newman v. Shearson, Hammill & Co.*, 383 F. Supp. 265, 268 (W.D. Tex. 1974).

143. *Newman v. Shearson, Hammill & Co. Inc.*, 383 F. Supp. 265, 268 (W.D. Tex. 1974); see *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Moore*, 590 F.2d 823, 828 (10th Cir. 1978); *Weissbuch v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 558 F.2d 831, 835 (7th Cir. 1977).

144. See *supra* note 142 and accompanying text.

to consider all the factors which supported the Court's decision in *Wilko*.¹⁴⁵

Lower courts have extended *Wilko* to 10b-5 claims arising under the Exchange Act, because section 29 of the Exchange Act¹⁴⁶ contains a non-waiver provision similar to section 14 of the Securities Act.¹⁴⁷ Section 29 of the Exchange Act provides that "[a]ny condition, stipulation or provision binding any person to waive compliance with any provision of this chapter or any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."¹⁴⁸

In reaching this conclusion, however, the courts have ignored several factors. In *Wilko*, the arbitration of the investor's claim was not compelled despite the Arbitration Act,¹⁴⁹ because of the combined effect of three specific and special provisions contained in the 1933 Act: section 14, the nonwaiver provision;¹⁵⁰ section 12, the special rights provision;¹⁵¹ and section 22, the special forum and service of process provision.¹⁵² In applying *Wilko* to 10b-5 claims the courts have disregarded the fact that the Exchange Act does not contain a special rights provision similar to section 12 of the Securities Act.¹⁵³ In fact, neither section 10(b) nor rule 10b-5 explicitly provides for a civil remedy.¹⁵⁴ Rather, as the *Scherk* court noted, a private cause of action thereunder has been judicially created.¹⁵⁵ The scope of the Exchange Act's jurisdictional provision¹⁵⁶ is also narrower than that of the Securities Act.¹⁵⁷ Although both section 22 of the Securities Act,¹⁵⁸ and section 27 of the Exchange Act¹⁵⁹ provide the plaintiff with nationwide service, the latter restricts jurisdiction to the federal courts,¹⁶⁰ whereas the former provides for jurisdiction in state and federal courts.¹⁶¹

It is illogical to insist that the general nonwaiver provision of the Ex-

145. *Wilko v. Swan*, 346 U.S. 427, 431-38 (1953). See *supra* notes 107-112.

146. 15 U.S.C. § 78cc(a) (1982).

147. *Id.* § 77n; see *Merrill Lynch, Pierce, Fenner, Smith, Inc. v. Moore*, 590 F.2d 823, 827 (10th Cir. 1978); *Starkman v. Seroussi*, 377 F. Supp. 518, 522 (S.D.N.Y. 1974); *Moran v. Paine, Webber, Jackson & Curtis*, 389 F.2d 242, 245 (3d Cir. 1968); *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178, 183 n.5 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

148. 15 U.S.C. § 78cc(a) (1982).

149. 9 U.S.C. §§ 1-14 (1982).

150. 15 U.S.C. § 77n (1982).

151. *Id.* § 77l.

152. *Id.* § 77v(a).

153. *Id.* § 77l.

154. See *supra* notes 135, 137-41 and accompanying text.

155. See *supra* notes 135, 140-44 and accompanying text.

156. 15 U.S.C. § 78aa (1982).

157. *Id.* § 77v(a).

158. *Id.*

159. *Id.* § 78aa.

160. *Id.*

161. *Id.* § 77v(a).

change Act¹⁶² overrides the Arbitration Act¹⁶³ in the same manner as section 14 of the Securities Act,¹⁶⁴ when the Exchange Act's nonwaiver provision¹⁶⁵ is not buttressed by special rights and broad jurisdictional provisions similar to those found in the Securities Act.¹⁶⁶ This is especially true because a private cause of action under section 10(b) of the Exchange Act is merely a judicially created action.¹⁶⁷ Moreover, by limiting the reach of *Wilko* to 1933 Act claims, the purpose of the Arbitration Act¹⁶⁸ is furthered and a cap is effectively placed on the problems which arise when a nonarbitrable federal securities claim is mixed with an arbitrable state claim.¹⁶⁹

Thus, although *Scherk* involved a 10b-5 claim arising out of an international securities transaction,¹⁷⁰ the Court's suggestion that the *Wilko* prohibition be limited to 1933 Act claims¹⁷¹ should be followed in domestic cases as well. The Supreme Court will have the opportunity to limit the *Wilko* prohibition to 1933 Act claims in *Byrd v. Dean Witter Reynolds, Inc.*,¹⁷² which is currently pending before the Court, and involves the arbitrability of state claims as well as a claim under section 10(b) of the Exchange Act.¹⁷³

B. Mixed Claims

A claimant will sometimes allege both federal securities law violations, which are not arbitrable without consent of the customer despite a pre-dispute arbitration clause, and arbitrable state law claims. What should

162. *Id.* § 78cc(a).

163. 9 U.S.C. §§ 1-14 (1982).

164. 15 U.S.C. § 77n (1982).

165. *Id.* § 78cc(a).

166. See *supra* notes 109-12 and accompanying text.

167. See *supra* notes 135, 139-41 and accompanying text.

168. 9 U.S.C. §§ 1-14 (1982).

169. See *infra* notes 174-206 and accompanying text for a discussion of these problems.

170. *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 515 (1974).

171. *Id.* at 513-14.

172. 726 F.2d 552 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 3509 (1984).

173. The Ninth Circuit in *Byrd* denied arbitration of the investor's 10b-5 claim because of *Wilko*. *Byrd*, 726 F.2d at 554. In addition, the court denied arbitration of the state claims because the court felt they were intertwined with the investor's 10b-5 claim. *Id.* See *infra* notes 174-206 and accompanying text for a discussion of the problems that arise when federal securities claims are mixed with state claims. In reaching its decision the Ninth Circuit never discussed the fact that the claim arose under the Exchange Act and not the Securities Act, and never referred to the Supreme Court's dicta in *Scherk* that *Wilko* should not apply to 10b-5 claims. See *supra* notes 137-41 and accompanying text. In deciding *Byrd*, the Supreme Court will have to decide whether to limit *Wilko* to 1933 Act claims or extend *Wilko* to 1934 Act claims. If the Court decides to extend *Wilko* to 1934 Act claims, it must establish a standard for resolving disputes when nonarbitrable federal securities claims are mixed with arbitrable state claims. See *infra* notes 174-205 and accompanying text. If, however, the Court decides to limit *Wilko* to 1933 Act claims, it will not be required to establish a standard for resolving mixed claims because the investor's federal securities claim in *Byrd* would be arbitrable along with his state claims.

a court do when faced with a motion to stay the litigation pending arbitration of the arbitrable claims?¹⁷⁴

1. Bifurcation

Where such mixed claims are severable, many courts have split them, citing a strong federal policy favoring liberal enforcement of arbitration agreements. This permits the arbitrable state claims to proceed to arbitration and the federal securities claims to be litigated.¹⁷⁵ Other courts, however, have stayed arbitration of the arbitrable claims until all the federal securities law claims have been determined.¹⁷⁶ Those courts justified this delay on the grounds that the facts giving rise to both sets of claims were similar, and to the extent similar, should be resolved in litigation rather than in arbitration.¹⁷⁷ Some commentators have suggested that:

[w]hen confronted with numerous state claims pendent to a federal securities law claim but subject to a valid arbitration agreement, a district court should sever the pendent claims, order them to arbitration, and stay the arbitration pending adjudication of the federal securities law claim retained in the district court. This solution of bifurcated resolution preserves the exclusive jurisdiction of the federal courts over Exchange Act claims, gives appropriate weight to the federal policy favoring arbitration, and enforces the contractual agreement of the parties.¹⁷⁸

Automatic bifurcation is not a complete answer to the problems

174. Indeed, to avoid the problem of *Wilko* and mixed claims, some SROs will not proceed with an arbitration against a public customer without his consent, unless a court order has been obtained.

175. See *Macchiavelli v. Shearson, Hammill & Co.*, 384 F. Supp. 21, 31 (E.D. Cal. 1974) (arbitrable contract claim severed from a Rule 10b-5 claim); Krause, *supra* note 85, at 710 (arbitrable pendent claims should be severed and proceed to arbitration).

176. See, e.g., *Peacock v. Oppenheimer & Co.*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,201, at 96,587 (N.D. Ill. Sept. 17, 1979); *Todd v. Oppenheimer & Co.*, 78 F.R.D. 415, 427 (S.D.N.Y. 1978).

177. See, e.g., *Peacock v. Oppenheimer & Co.*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,201, at 96,587 (N.D. Ill. Sept. 17, 1979); *Todd v. Oppenheimer & Co.*, 78 F.R.D. 415, 426 (S.D.N.Y. 1978). But see *DeHart v. Moore*, 424 F. Supp. 55, 57 (S.D. Fla. 1976) (court permitted arbitration to proceed even though state and common law claims were based on same facts).

178. *Bell & Fitzgerald*, *supra* note 133, at 853 (footnote omitted); see *Peacock v. Oppenheimer & Co.*, [1979-80 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,201, at 96,587 (N.D. Ill. Sept. 17, 1979). In *Peacock*, the court stated that

By compelling arbitration of the common law counts in plaintiffs' complaint, we believe we are only ordering the parties to do that which they bargained for. Concededly, there is likely to be some duplication of effort between the judicial proceeding concerning Count I and the arbitration proceedings. We will stay arbitration until after the trial on Count I, however, and assume that the arbitrators will be influenced by our resolution of those issues common to both proceedings.

Id.; see also *Dickinson v. Heinold Sec., Inc.*, 661 F.2d 638, 644 (7th Cir. 1981) (In a bench trial, "detailed findings of fact . . . should eliminate much of the duplication through the impact of collateral estoppel on the subsequent arbitration.").

caused by mixed claims, because even if the arbitrable claims are stayed pending disposition of the federal securities claims, the question arises as to what extent "similar" or "related" findings of fact in the federal securities suit would be binding in the subsequent arbitration on the grounds of res judicata or collateral estoppel. Indeed, because arbitrators are not bound by the customary doctrines of substantive law, it is not clear what res judicata or collateral estoppel effect arbitrators would accord to a prior judgment.¹⁷⁹ Thus, similar or factually related issues might still be tried in two different forums.¹⁸⁰

2. Intertwining

When it is impractical if not impossible to separate arbitrable state claims from nonarbitrable federal securities claims—for example, when the issue of churning a customer's account is the basis of both the federal securities claim as well as the state claims¹⁸¹—some courts have held that arbitration as to the arbitrable claims should be denied and that all issues should be tried together.¹⁸² This approach has been referred to as the "doctrine of intertwining."¹⁸³ This exception to the general rule that arbitrable claims should be referred to arbitration was developed in order to preserve the exclusive jurisdiction of the federal courts in areas where such exclusivity exists.¹⁸⁴ For example, the court in *Cunningham v. Dean Witter Reynolds, Inc.*¹⁸⁵ stated that "[the Arbitration Act's] goal of avoiding litigation where arbitration would be cheaper and faster would be disserved if the court were to bifurcate the proceedings and compel arbitration of the pendent claims."¹⁸⁶ In cases where the federal and

179. See N.Y. Civ. Prac. Law § 7511, commentary at 7511:5, at 582 (McKinney 1982) (commentary by Joseph M. McLaughlin). But see *Dickinson v. Heinold Sec., Inc.*, 661 F.2d 638, 644 (7th Cir. 1981).

180. See *infra* note 201 and accompanying text. In addition, the automatic stay of the arbitrable claims pending disposition of the federal securities claim would give the parties the benefit of discovery obtained in the court action in any subsequent arbitration. See *supra* note 52 and accompanying text.

181. See *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 335 (5th Cir. 1981).

182. See, e.g., *id.* at 335; *Sibley v. Tandy Corp.*, 543 F.2d 540, 544 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977).

183. See *Miley*, 637 F.2d at 335; *Cunningham v. Dean Witter Reynolds, Inc.*, 550 F. Supp. 578, 581 (E.D. Cal. 1982).

184. See *Byrd v. Dean Witter Reynolds Inc.*, 726 F.2d 552, 554 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 3509 (1984); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 335 (5th Cir. 1981); see also *Sibley v. Tandy Corp.*, 543 F.2d 540, 543 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977) (denial of arbitration is justified in a case where "arbitrator making a decision on the common law claims would have been impelled to review the same facts needed to establish the plaintiff's securities law claim"). In *Sibley*, however, the federal securities law claim was pleaded in the alternative, and its existence depended on the resolution of the contractual dispute. *Sibley*, 543 F.2d at 544 n.5. The Court "therefore ordered that . . . the federal securities claim and other pendent state claims be stayed pending resolution of the contractual dispute through arbitration." *Bell & Fitzgerald*, *supra* note 133 at 852 n.22 (citing *Sibley*, 543 F.2d at 544 n.5).

185. 550 F. Supp. 578 (E.D. Cal. 1982).

186. *Id.* at 585.

state claims are inseparable, arbitration will not provide a cheaper forum because the federal claims will have to be litigated separately, and thus the goal of avoiding litigation through arbitration is unattainable.

This conclusion, however, does not comport with the legislative history of the Arbitration Act,¹⁸⁷ which emphasizes the congressional goal of enforcement of contractual commitments.¹⁸⁸ Nor is the court's conclusion consistent with the Supreme Court's recent statement in *Moses H. Cone Memorial Hospital v. Mercury Construction Corp.*¹⁸⁹ that "the relevant federal law requires piecemeal resolution when necessary to give effect to an arbitration agreement."¹⁹⁰ Indeed, the Seventh Circuit, in *Dickinson v. Heinold Securities, Inc.*,¹⁹¹ held that the alleged inefficiency was "somewhat speculative," and insufficient to destroy the right to arbitration.¹⁹² The court further concluded that "[t]he intertwining doctrine would always threaten to become the exception that swallowed the rule, allowing the presence of a non-arbitrable claim to force a trial on the otherwise arbitrable claims."¹⁹³

3. Alternatives

The split among the circuit courts concerning the treatment of mixed claims¹⁹⁴ may soon be resolved by the Supreme Court in *Byrd v. Dean Witter Reynolds, Inc.*¹⁹⁵ In *Byrd*, the Ninth Circuit affirmed the district court's decision to deny Dean Witter's motion to compel arbitration,¹⁹⁶ stating that under *Wilko* the arbitration of claims arising under the Ex-

187. 9 U.S.C. §§ 1-14 (1982).

188. Bell & Fitzgerald, *supra* note 133, at 853.

189. 460 U.S. 1 (1983).

190. *Id.* at 20 (emphasis in original); see *Southland Corp. v. Keating*, 104 S. Ct. 852, 859 (1984); *Surman v. Merrill Lynch, Pierce, Fenner & Smith*, 733 F.2d 59, 63 (8th Cir. 1984).

191. 661 F.2d 638 (7th Cir. 1981).

192. *Id.* at 644.

193. *Id.* at 645-46; see Brodsky & Frumento, *Arbitration and the Securities Laws*, 15 Rev. Sec. Reg. 850, 854 (1982).

194. The Ninth, Fifth and Eleventh Circuits have all adopted the intertwining doctrine. See *Byrd v. Dean Witter Reynolds, Inc.*, 726 F.2d 552, 554 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 3509 (1984); *Belke v. Merrill Lynch, Pierce, Fenner & Smith*, 693 F.2d 1023, 1026 (11th Cir. 1982); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Haydu*, 675 F.2d 1169, 1172-73 (11th Cir. 1982); *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 335 (5th Cir. 1981); *Sibley v. Tandy Corp.*, 543 F.2d 540, 543 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977). The Sixth, Seventh, and Eighth Circuits have all rejected the doctrine. *Surman v. Merrill Lynch, Pierce, Fenner & Smith*, 733 F.2d 59, 62 (8th Cir. 1984); *Liskey v. Oppenheimer & Co.*, 717 F.2d 314, 317-20 (6th Cir. 1983); *Dickinson v. Heinold Sec., Inc.*, 661 F.2d 638, 643-46 (7th Cir. 1981); see also *Kavit v. A.L. Stamm & Co.*, 491 F.2d 1176, 1182 (2d Cir. 1974) (intertwining doctrine rejected in dictum). Similarly, the D.C. Circuit has rejected the doctrine of intertwining when arbitrable pendent state claims were joined with nonarbitrable federal antitrust claims. *Lee v. Ply*Gem Indus., Inc.*, 593 F.2d 1266, 1274-75 (D.C. Cir.), *cert. denied*, 441 U.S. 967 (1979).

195. 726 F.2d 552 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 3509 (1984).

196. *Id.* at 554.

change Act was not compelled.¹⁹⁷ The court explained that

when there are arbitrable and nonarbitrable claims arising out of the same transaction, the district court should have discretion to evaluate the degree to which the claims are intertwined. If the district court determines that they are so intertwined that the purposes of the Arbitration Act and the protective intent of the federal securities laws would be frustrated by separating the claims, then it should refuse to separate them.¹⁹⁸

If the Supreme Court agrees that *Wilko* applies to claims under the 1934 Act, the Court must then determine how these claims should be resolved when they are mixed with state claims.¹⁹⁹ Regardless of what standard the Supreme Court adopts, many of the problems involving intertwined securities claims will persist as long as the *Wilko* exception to arbitration agreements survives.²⁰⁰ If the Court establishes a rule of automatic bifurcation, for example, similar or factually related issues may be tried before different forums, resulting in unnecessary delay, duplication and inconvenience.²⁰¹ On the other hand, if the court establishes a rule of strict prohibition against severance, lawyers may be encouraged to plead colorable federal securities claims, thereby systematically preventing the arbitration of independent claims based upon state law.²⁰² Assuming the *Wilko* prohibition continues to exist, a rule of automatic bifurcation or strict prohibition against severance should be avoided and the trial court should be given some discretion to sever or join the claims, depending upon the equities before it. A policy generally favoring bifurcation seems preferable, except where the facts of the arbitrable and nonarbitrable claims are clearly inseparable and the securities law claim is more than

197. *Id.*

198. *Id.*

199. See *supra* note 173 and accompanying text.

200. See *supra* notes 92-117, 176-95 and accompanying text.

201. In an era of calendar congestion, see *supra* note 6, this potential for duplication and delay is ill-advised. See *supra* note 179 and accompanying text for a discussion of what, if any, collateral estoppel effect a federal securities suit would have on a subsequent arbitration. Automatic bifurcation also runs contrary to the federal policy of pendent jurisdiction, which encourages parties to resolve their claims in one proceeding. See *United Mineworkers v. Gibbs*, 383 U.S. 715, 725-27 (1966); Krause, *supra* note 85 at 717.

202. Under liberal pleading rules in federal courts, see *Droppleman v. Horsley*, 372 F.2d 249, 250 (10th Cir. 1967); *Barnes v. Irving Trust Co.*, 290 F. Supp. 116, 117 (S.D. Tex. 1968), the specious nature of federal securities claims may not be apparent until after extensive discovery or a lengthy trial, thus delaying arbitration procedures that should have been immediately available to the parties. "[T]he typical mixed arbitrable/nonarbitrable claims case involves a 10b-5 action and various pendent state claims such as common law fraud, breach of contract, or breach of fiduciary duty asserted as independent claims all arising out of the same factual scenario" Bell & Fitzgerald, *supra* note 133, at 852 n.22. The difference between the two types of claims often revolves around mental state—an element that can be established only after a trial. For example, "whereas negligence could support a claim for breach of fiduciary duty and no mental state need be shown for breach of contract, scienter is an element of an action under rule 10b-5." Krause, *supra* note 85, at 712 (footnotes omitted). See *supra* note 136 and accompanying text.

"the rather small tail to a much larger dog."²⁰³ Discretionary bifurcation will help to avoid the problems caused when a sham 10b-5 claim is pleaded in order to prevent or delay arbitration, and the congressional mandate favoring arbitration—as evidenced by the Arbitration Act²⁰⁴—will be furthered, and should prevail over the judicially created doctrine of intertwining. A better solution, however, is to judicially limit the reach of *Wilko* by not extending it to 1934 Act claims²⁰⁵ or legislatively abolishing the *Wilko* exception in order to avoid the problems caused when federal securities claims are pleaded with state claims.²⁰⁶

C. Contract of Adhesion

Another basis for refusing to enforce an arbitration agreement is the doctrine of "adhesion."²⁰⁷ Adhesion arises when a standardized contract, usually drafted by a party of superior bargaining power, is presented to a party whose choice is limited to accepting or rejecting the contract without the opportunity to negotiate its terms.²⁰⁸ Such agreements are usually used when a party enters into similar transactions with many individuals,²⁰⁹ and the agreements resemble ultimatums or laws rather than mutually negotiated contracts.²¹⁰

Generally, there are two judicially imposed limitations on the enforce-

203. *Sibley v. Tandy Corp.*, 543 F.2d 540, 543 (5th Cir. 1976), *cert. denied*, 434 U.S. 824 (1977). Admittedly, granting such discretion might cause some forum shopping, but automatic bifurcation hardly seems a workable panacea. See *supra* note 201 and accompanying text.

204. 9 U.S.C. §§ 1-14 (1982).

205. The claim protected in *Wilko* involved the special right of an aggrieved purchaser, under § 12 of the Securities Act, 15 U.S.C. § 771 (1982), to recover for misrepresentation. In such a case, the burden shifts to the seller to prove the lack of scienter. See *supra* notes 100-104 and accompanying text. This is not the case with a 1934 Act claim, particularly when the cause of action is judicially implied under § 10b. See *supra* notes 107-144 and accompanying text. To hold an agreement to arbitrate unenforceable when the dispute involves a 10b claim is to elevate a judicially implied right of action to the level of a special right created by Congress under § 12 of the Securities Act. 15 U.S.C. § 771 (1982). In view of the strong Congressional policy favoring arbitration and the serious problems of intertwining and bifurcation that arise when federal security claims are mixed with state claims, see *supra* notes 178-202 and accompanying text, *Wilko* should not be extended to 1934 Act claims.

206. The *Wilko* exception should be abolished, however, only if a separate organization is established to govern arbitrations. See *infra* notes 259-63 and accompanying text.

207. See Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 Colum. L. Rev. 629, 630-33 (1943); Murray, *Unconscionability: Unconscionability*, 31 U. Pitt. L. Rev. 1, 28-34 (1969); see Wright, *Arbitration Clauses in Adhesion Contracts*, 33 Arb. J., June 1978, at 41, 42.

208. J. Calamari & J. Perillo, *Contracts* § 1-33, at 6 (2d ed. 1977); see Quinn, *Uniform Commercial Code Commentary and Law Digest* ¶ 2-302[A], at ¶ 2-95-96 (1978).

209. Kessler, *supra* note 207, at 631; Lenhoff, *Contracts of Adhesion and the Freedom of Contract: A Comparative Study in the Light of American and Foreign Law*, 36 Tul. L. Rev. 481, 481-82 (1962).

210. *Siegelman v. Cunard White Star Ltd.*, 221 F.2d 189, 206 (2d Cir. 1955); see Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529, 553 (1971).

ment of adhesion contracts or their provisions.²¹¹ First, regardless of any general "duty to read," such a contract or provision which does not fall within the reasonable expectations of the weaker or 'adhering' party will not be enforced against him.²¹² Second, a contract or a provision, even if consistent with the reasonable expectations of the parties, will be denied enforcement if, considered in its context, it is unduly oppressive, unconscionable or against public policy.²¹³ A great deal has been written about the interrelationship of the duty to read, reasonable expectations, unconscionability and public policy,²¹⁴ and it is unnecessary to review this material. Instead, let us narrow the inquiry to the subject at hand by making certain assumptions.

Assume that a customer is required to sign an arbitration clause typical of those found in standard broker-customer securities agreements before he can open an account.²¹⁵ Would a customer be relieved of his arbitration obligation because there was no duty to read, and consequently no true assent? Apparently not, because the investor could reasonably have expected to find a pre-dispute arbitration clause in the agreement.²¹⁶ Would such a clause be contrary to public policy? Again, it would appear not, because of the policies underlying the federal Arbitration Act.²¹⁷

A more interesting question is whether such a typical industry-wide arbitration agreement, imposed by the securities industry upon its customers,²¹⁸ is unenforceable as unduly oppressive or unconscionable. The federal Arbitration Act²¹⁹ does not render this point moot, because even though this type of transaction constitutes "commerce" and is therefore covered by the Act, there is an exception when grounds exist at law or in equity for the revocation of any contract.²²⁰

211. *Graham v. Scissor-Tail, Inc.*, 28 Cal. 3d 807, 818, 623 P.2d 165, 172-73, 171 Cal. Rptr. 604, 612 (1981).

212. *Id.*

213. *See Id.*; cf. *Chretien v. Donald L. Bren. Co.*, 151 Cal. App. 3d 385, 388, 198 Cal. Rptr. 523, 525, (1984) (court may deny enforcement of a nonadhesive contract if terms are unconscionable, or may limit application of any unconscionable clause). It would appear, however, that the burden of establishing unconscionability is greater in the case of a freely negotiated contract than it is when a party of superior bargaining power imposes an industry-wide form upon the weaker party. *See Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358, 386, 161 A.2d 69, 84 (1960). One commentator has noted that "[a]n arbitration clause is especially vulnerable to attack if one party has not voluntarily agreed to it, because a fundamental factor in the courts' willingness to enforce arbitration clauses is their voluntary nature." Wright, *supra* note 207, at 43 (footnote omitted).

214. *See J. Calamari & J. Perillo, supra* note 208, § 9-37-46, at 316-47; Kessler, *supra* note 207, at 630-35; Murray, *supra* note 207, at 14-34; Slawson, *supra* note 210, at 549-61.

215. *See supra* note 119 and accompanying text. For a discussion of whether customers, as a practical matter, are generally precluded from dealing with broker-dealers unless they sign such agreements, *see supra* note 86.

216. *See supra* note 86 and accompanying text.

217. 9 U.S.C. §§ 1-14 (1982). *See supra* notes 104-106 and accompanying text.

218. *See supra* note 86.

219. 9 U.S.C. §§ 1-14 (1982).

220. *Id.* § 2.

In *Graham v. Scissor-Tail, Inc.*²²¹ the California Supreme Court held that a music promoter was not bound by an arbitration award rendered pursuant to the rules of the American Federation of Musicians (AFM), despite his agreement to arbitrate according to those rules.²²² The court stated that the agreement to arbitrate according to AFM rules was a contract of adhesion and unconscionable.²²³ The rules allowed a member of the union (in fact, one of its executive officers) to be an arbitrator, and having an arbitrator so aligned with one party was "so inimical to fundamental notions of fairness as to require nonenforcement."²²⁴

Shortly after *Scissor-Tail*, the California Court of Appeals rendered a somewhat related decision in *Hope v. Superior Court of Santa Clara County*.²²⁵ *Hope* involved two Shearson Hayden Stone, Inc. (Shearson) account executives who sued Shearson for commissions.²²⁶ Shearson moved to stay the proceedings and compel arbitration on the basis of an employment application form supplied by the New York Stock Exchange (NYSE), of which Shearson was a member.²²⁷ This form contained an agreement to arbitrate any controversy arising out of the employment in accordance with the arbitration procedures of the NYSE.²²⁸ Having decided that the employment contract was one of adhesion,²²⁹ the court proceeded to address the issue of whether the arbitration procedures of the NYSE were unconscionable. After emphasizing that it did not find actual bias on the part of the NYSE,²³⁰ the *Hope* court pointed out that the "structure of governance of the Exchange is such that there exists a presumptive *institutional* bias in favor of member firms and members who constitute the electoral constituency of the board."²³¹ The petitioners, "being outside that constituency, [had] legitimate cause to complain."²³²

The court in *Hope* was unimpressed that the arbitrators were persons not engaged in the securities business, that the customer had a peremptory challenge and that the Director of Arbitration of the SRO had the authority to disqualify an arbitrator.²³³ Instead, the court pointed out that

[e]venhandedness could be assured by a procedure which permits selection of arbitrators by the parties to the dispute or, failing that,

221. 28 Cal. 3d 807, 623 P.2d 165, 171 Cal. Rptr. 604 (1981).

222. *Id.* at 831, 623 P.2d at 180, 171 Cal. Rptr. at 619.

223. *Id.* at 826, 623 P.2d at 177, 171 Cal. Rptr. at 616.

224. *Id.* at 821, 623 P.2d at 174, 171 Cal. Rptr. at 613.

225. 122 Cal. App. 3d 147, 175 Cal. Rptr. 851 (1981).

226. *Id.* at 149, 175 Cal. Rptr. at 853.

227. *Id.*

228. *Id.*

229. *Id.* at 153, 175 Cal. Rptr. at 855.

230. *Id.* at 154, 175 Cal. Rptr. at 856.

231. *Id.* (emphasis in original).

232. *Id.*

233. *Id.* at 155, 175 Cal. Rptr. at 856.

through the auspices of some truly neutral party. In the absence of such a procedure we must conclude, as in *Scissor-Tail*, that the arbitration procedures of the New York Stock Exchange fail to meet minimal levels of integrity.²³⁴

The California Court of Appeals reached a distinctly different conclusion, however, in *Parr v. Superior Court of San Mateo*,²³⁵ a case involving an arbitration clause in a broker-customer agreement. Although the *Parr* Court adopted the presumptive bias test of *Hope*,²³⁶ it ruled that the presumption was rebutted by its finding that the arbitration procedures of the NYSE were not unfair.²³⁷ The arbitration agreement thus was enforceable.

Only time will tell what effect the doctrine of adhesion will have on the enforceability of pre-dispute securities arbitration agreements.²³⁸ If courts view standardized industry contracts containing arbitration clauses as presumptively unfair, and therefore unenforceable, a shadow may be cast over the effectiveness of pre-dispute arbitration clauses for the foreseeable future²³⁹ even in cases where *Wilko* would be inapplicable. Courts should not view pre-dispute arbitration clauses as unconscionable, however, if the arbitration procedures are fair and involve public participation.

IV. IMAGE OF FAIRNESS

In light of Congress' refusal to permit the public to waive its rights under the Securities Act,²⁴⁰ and the possible unenforceability of arbitra-

234. *Id.*; see *Richards v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 64 Cal. App. 3d 899, 903-04, 135 Cal. Rptr. 26, 28-29 (1976). See *infra* notes 245-54 and accompanying text.

235. 139 Cal. App. 3d 440, 446-47, 188 Cal. Rptr. 801, 805 (1983).

236. *Id.* at 447, 188 Cal. Rptr. at 805.

237. *Id.* In reaching its decision the court noted that the arbitration procedures outlined in the NYSE rules had been approved by the SEC. *Id.*

238. See Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 Harv. L. Rev. 1173, 1176 (1982). Professor Rakoff contends, in contrast to most current statements in this area, that "the form terms present in contracts of adhesion ought to be considered presumptively (although not absolutely) unenforceable." *Id.*

239. *Cf.* J. Calamari & J. Perillo, *supra* note 208, § 9-46, at 347 ("If the industries that employ standard forms do not police themselves so as to insure inherent fairness of forms, it is likely that the courts will increasingly refuse legal effect to non-negotiated terms of a contract and that standardized forms, as in the case of insurance policies, will be dictated by legislatures or administrative agencies."). In addition, if a court concludes that a customer's agreement containing a pre-dispute arbitration clause is in fact a prerequisite for general access to the securities markets, it could also conceivably take the extreme position that the arbitration clause therein was per se unenforceable, because the agreement was entered into without choice. Should that ultimately become the prevailing view, a voluntary system wherein the execution of an arbitration agreement is not a prerequisite to arbitration would still be practical and advisable. See *supra* note 124 (discussing voluntary procedures under the Commodity Exchange Act); *cf.* 7 U.S.C. §§ 7-26 (1982) (voluntary procedures under the Commodity Exchange Act).

240. 15 U.S.C. § 77n (1982). See *supra* notes 92-108 and accompanying text.

tion agreements because of the doctrine of adhesion,²⁴¹ arbitration will never be an accepted method for resolving securities disputes unless the public perceives that arbitration procedures are fair in fact and appearance. "[J]ustice should not only be done, but should manifestly and undoubtedly be seen to be done."²⁴² Although a fair arbitration code has been prepared,²⁴³ it is only as good as its application. In this regard, the selection of arbitrators is of crucial importance and is an area in which vigilance must constantly be exercised.²⁴⁴

The SICA Procedures Booklet provides that arbitrators are to be impartial persons who are knowledgeable in the areas in controversy.²⁴⁵ Each sponsoring organization maintains a roster of individuals who are not employees of the sponsoring organization but whose professional qualifications and experience qualify them for service as arbitrators.²⁴⁶ The Director of Arbitration of the SRO appoints the panel of arbitrators,²⁴⁷ sometimes by the "roll of the drum",²⁴⁸ and on other occasions with an effort to match the problems of the case with the expertise of the arbitrators. As a safeguard to public customers, the Uniform Code of Arbitration clearly provides that unless the public customer requests otherwise, the matter will be arbitrated by a panel "at least a majority of whom shall not be from the securities industry."²⁴⁹ No further guidance is given by the Code as to who qualifies to be a "public arbitrator." Only a slight clarification was provided by the original version of the Procedures Booklet, which described public arbitrators as "individuals who are neither associated with, nor employed by a broker-dealer or securities industry organization."²⁵⁰

The Code and Booklet left several questions unanswered. For example, does the fact that someone was once associated with the securities industry disqualify him as a public arbitrator? Similar questions arose concerning the person who owns publicly traded stock of a brokerage house or who services clients in the securities industry, such as an attorney or a public accountant. Finally, would SICA disqualify an employee of a corporation that is not in the securities business but that is either a parent or subsidiary of a brokerage house?

241. See *supra* notes 207-39 and accompanying text.

242. *Richards v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 64 Cal. App. 3d 899, 903, 135 Cal. Rptr. 26, 28 (1976) (quoting *King v. Sussex Justices*, (1924) 1 K.B. 256, 259). See *infra* notes 261-62 and accompanying text.

243. See *supra* notes 29-84 for a description of general procedures under the Uniform Code of Arbitration.

244. See *supra* notes 233-37 and accompanying text.

245. See Procedures Booklet, *supra* note 23, at 3.

246. *Id.*

247. Uniform Code of Arbitration, *supra*, note 21, § 8(b).

248. The "roll of the drum" procedure is a random selection similar to choosing a winner of a raffle.

249. Uniform Code of Arbitration, *supra* note 21, § 8(a)(1), (2). Such persons are commonly referred to by SICA as Public Arbitrators.

250. Procedures Booklet, *supra* note 23, at 3.

The definition of a public arbitrator has been repeatedly discussed within SICA. Two conflicting equities had to be considered: On the one hand was the desire to insure impartiality for the public customer, and on the other hand was the desire to avoid making the definition so rigid and narrow as to disqualify anyone who has ever dealt with the securities industry, thereby stripping panels of valuable experience. Moreover, in an era of financial supermarkets²⁵¹ it is possible to argue that employees of businesses totally uninvolved in the securities field are associated—through corporate or joint ownership—with a business that is a part of the securities industry. Such rigidity would hamper efforts to provide an effective and convenient forum with experienced and geographically diverse arbitrators. Accordingly, after much debate, SICA revised the Procedures Booklet by adding the following classification section:²⁵²

Guidelines for the Classification of Persons as Public Arbitrator:

No one may serve as a public arbitrator who has been an employee or partner of a member organization or subsidiary thereof, or a shareholder of a non-publicly owned member organization or subsidiary thereof for a period of three years immediately preceding his or her appointment as as public arbitrator.

Additional information concerning a particular arbitrator may be obtained by a party or the party's attorney upon request directed to the Director of Arbitration prior to the commencement of the hearing or a submission to the arbitrator without a hearing.²⁵³

Despite its general feeling that the selection of public arbitrators has been professionally and ethically carried out,²⁵⁴ SICA included the provision enabling a party to request additional information concerning a public arbitrator in order to guard against any feeling of impropriety.²⁵⁵ For this reason, while it appears that the proposed classification section is workable, it must be applied with vigilance and good judgment by the respective Directors of Arbitration of the various SROs.

If, for example, a person owned one million shares of Merrill Lynch, Pierce, Fenner & Smith Inc. common stock, the Arbitration Director should not designate him as a public arbitrator, even though he is not disqualified by the revised classification section, and even if he were universally held to be exceptionally honorable and trustworthy. Similarly, if an attorney has represented one securities broker, only and exclusively, for the last twenty years, an Arbitration Director should not designate

251. An example of a financial supermarket is a holding company that owns securities, banking, insurance, real estate and other related businesses.

252. Although the change is not being inserted directly into the Code itself, it is felt that insertion in the Booklet will make it of binding effect on the SROs. Fourth Report, *supra* note 7, at Exhibit B—Procedures Booklet.

253. *Id.*

254. *Id.* In light of this provision every effort should be made to keep records concerning the affiliation and experience of public arbitrators updated and kept current to the extent possible.

255. See *supra* notes 240-42 and accompanying text.

such an attorney as a public arbitrator. In short, SICA has purposely kept flexible the section governing classification of public arbitrators for the good of both the public and the securities industry itself. Otherwise, the vast experience of many needed and qualified persons would be lost. The Directors of Arbitration, however, in the exercise of their discretion must be vigilant to avoid suspicion on the part of the public.

CONCLUSION

It has been this author's experience that the securities arbitration procedures have, to date, resulted in an overall good faith effort to provide fair resolution of public securities disputes. As the markets of the next decade expand and become increasingly diverse and complex, however, the controversies arising out of the handling of such transactions will increase and become more difficult to resolve. Present arbitration procedures—no matter how effective in the past—must be streamlined and adjusted to meet that challenge.

To be effective and fair to all the parties, convenient security arbitration forums must be available throughout the country on a continuous and permanent basis.²⁵⁶ This requires the provision of numerous hearing locations and the availability of a large pool of widely dispersed, impartial and experienced arbitrators—a tall order and one made even more difficult if duplicated by differing SROs. Although adequate coverage is currently provided through the efforts of SRO arbitration staffs, the situation will be complicated and strained by the explosion of arbitration filings, present and anticipated.²⁵⁷ Accordingly, efforts should be made to consolidate arbitration forums. Pools of experienced public arbitrators should be combined and shared,²⁵⁸ and internal administrative procedures should be made uniform.

Ideally, securities arbitration should be moved from the SROs themselves to a totally independent organization²⁵⁹ governed by members of the public and the securities industry.²⁶⁰ If a separate forum is not pres-

256. See *supra* notes 69-70 and accompanying text.

257. See *supra* notes 6-7 and accompanying text.

258. Most SROs presently keep their own lists of arbitrators. See *Procedures Booklet*, *supra* note 23, at 3.

259. An analogous concept has proved workable in the accounting field. In fact, since 1977, some of the trustees of the Financial Accounting Foundation (FAF) have been selected by electors outside the accounting profession. See *Financial Accounting Standards Board, Status Report No.68 at 2* (June 21, 1978). The FAF appoints, oversees and finances the Financial Accounting Standards Board (FASB), which is responsible for formulating the rules by which companies account and report their financial condition. *Id.* at 1-2; see *Horngren, Introduction To Financial Accounting* 57-58 (2d ed. 1984).

260. These public and industry representatives should have total responsibility for the appointment of arbitrators and the government of the arbitration forums. Indeed, the SEC has expressed its concern regarding possible public apprehension over the impartiality of officials associated with SROs. See *Investor Dispute System*, *supra* note 17, ¶ 81,136, at 87,906. An independent forum will also help insulate an SRO from any potential conflicts of interests that might arise from the fact that the SRO supplies the

ently feasible, the SROs should consolidate their programs and then amend their procedures to include direct and meaningful public participation in the administration thereof, for it is vitally important to the health and stability of the securities markets that the public perceive arbitration forums as independent.²⁶¹

To insure . . . public investment we must retain the public's confidence—confidence in the markets themselves and confidence that should a dispute arise, it will be fairly resolved. This confidence, however, can only be earned by maintaining a *de facto* as well as a *de jure* image of fairness. In other words, the procedural rules must be fair and the administration of the forum must be objective and independent; [moreover,] such administration should include public representation.²⁶²

Once meaningful public participation in the administrative process of public securities arbitrations is achieved, the *Wilko* restraint can be abolished,²⁶³ because Congress' interest in protecting the rights of securities investors will be adequately served.²⁶⁴ Removal of the *Wilko* restraint would in turn do away with the inconvenience and waste caused by the present problem of the intertwining of arbitrable and nonarbitrable disputes.²⁶⁵ A specialized but independent arbitration forum would also help alleviate the troublesome problem of adhesion by reducing the possibility that a court would find bias on the part of the administering

arbitration forum. For example, does the arbitration department of an SRO have any duty to reveal to the enforcement and disciplinary branch of that same SRO any improprieties it discovers during the arbitration? To what extent is an SRO vulnerable to SEC inquiry concerning the details of a particular arbitration proceeding specifically, or arbitration proceedings generally?

It is doubtful whether an independent forum would increase the cost of arbitration. In any case, such a rise in cost could easily be funded by a small mandatory surcharge imposed upon each securities transaction. Moreover, the cost is negligible in view of the alternatives—namely, distrust of arbitration, splitting of intertwined claims and extended litigation in the courts. See *supra* notes 174-93 and accompanying text.

261. See *supra* section IV.

262. Statement of Constantine N. Katsoris before the Securities & Exchange Commission (Dec. 8, 1977) (available in files of *Fordham Law Review*).

263. Admittedly, abolishing *Wilko* will not be a total panacea in all cases. For example, a party injured in the purchase of a new issue of securities might conceivably have a claim under the 1933 Act against the issuer, the underwriter, his broker and the certifying accountant. Requiring arbitration of his claim against his broker would necessitate his pursuing a separate action against the others with whom he has no agreement to arbitrate. Such infrequent inconvenience, however, is, in the great majority of disputes between the securities industry and its customers, far outweighed by the removal of the delays and uncertainties presently raised by *Wilko*. See *supra* notes 131-205 and accompanying text for a discussion of such problems. In addition, if Congress were to abolish the *Wilko* exception for the "special right" created under § 12(2) of the 1933 Act, 15 U.S.C. § 77i(2) (1982), it might also consider providing the advantage of national service on witnesses in the arbitration of federal securities claims. Just as Congress has the authority to provide for a nation-wide service for federal claims, Fed. R. Civ. P. 45(e), it appears that Congress could provide such a measure in the Arbitration Act.

264. See *supra* notes 100-08 and accompanying text.

265. See *supra* notes 182-206 and accompanying text.

forum.²⁶⁶

Finally, what is SICA's future role, if any? It could be allowed to die a quiet death; or, having worked successfully once, it could be used as a forum workshop for the resolution of future industry/public arbitration disputes. In this role, it could act as the catalyst for the ultimate evolution of one national independent securities arbitration system that would be both economical and free from even the most paranoid charge of partiality.

266. See *supra* notes 221-34 and accompanying text.